

R E S O U R C E S

N A T U R A L

EXHIBIT 2
DATE 3-7-07
SB 25

A Report to the Legislature
Contract Harvesting Program

September 2006



WASHINGTON STATE DEPARTMENT OF
Natural Resources
Doug Sutherland - Commissioner of Public Lands

This report was prepared by the
Washington State Department of Natural Resources

September 2006

For more information, contact:

Bruce Mackey
Lands Steward
(360) 902-1101

Michael Eklund-Grayum
Governmental Relations Director
(360) 902-1015

Preface

In 2003, the Legislature authorized the Washington State Department of Natural Resources (DNR) to contract for the harvest of timber from forested state trust lands. The Legislature found that "it is in the best interest of the trust beneficiaries to capture additional revenues while providing for additional environmental protection on timber sales. Further, the legislature finds that contract harvesting is one method to achieve these desired outcomes."¹ The legislation directed DNR to establish and implement a Contract Harvesting program that would meet two objectives: earn additional revenues for the trust beneficiaries, and provide additional environmental protection on timber sales. The Legislature further stated that... "By December 31, 2006, the Department of Natural Resources must provide a report to the appropriate committees of the legislature that provides an accounting of the costs and effectiveness of the contract harvesting program."² This is the required report.

Contract Harvesting Program

Background

The state Department of Natural Resources (DNR) has historically sold timber from forested state trust lands by identifying the timber to be sold, marking the boundaries and protected features, creating a contract that details the terms and conditions of the timber sale, and appraising each sale. These timber sales are then presented to the Board of Natural Resources (Board) for their review. The Board must approve and set the minimum bid to be accepted for each timber sale, which is then sold at public auction. The successful high bidder is awarded a contract to harvest and remove the timber within a specified time period. These traditional timber sales methods are categorized as either lump sum sales, where the timber is sold on a cash basis, or scale sales, where the timber is sold by either the scaled volume (in thousand board feet) or weight (in tons).

Unlike lump sum or scale sales in which all of the timber is sold to one bidder, DNR also uses the Contract Harvesting sale method, which allows individual log sorts to be sold at public auction. Log sorts are a selection of logs that can be used for a singular end use product, such as two-by-fours, sheeting for plywood, or logs for log homes. DNR uses an open and competitive process to select the most highly qualified professionals to harvest the log sorts. DNR then contracts with these harvesting companies to harvest and haul the timber. DNR identifies the log sort specifications and determines other harvesting activities that the harvester must use to deliver log sorts to the log purchasers

¹ Chapter 313, Laws of 2003 (2SSB 5074); Amended in Chapter 218, Laws of 2004 (2SSB 6144).

² Ibid.

under contract. Contract Harvesting allows DNR to control harvest timing and to better address and meet sensitive and complicated environmental commitments by directly controlling the harvesting activities. In some specially selected situations, DNR can earn more revenue for the trusts by using the Contract Harvesting method to sell log sorts rather than using lump sum or scales sale methods.

The 'gross proceeds' from the sale of these log sorts are deposited into the Contract Harvesting Revolving Account. The related harvesting costs are then paid to the harvester from this account. After all the costs of a Contract Harvesting timber sale are paid, the remaining funds ('net proceeds') are then transferred to the State Treasurer for distribution to the appropriate state trust account(s).

Contract Harvesting Sales Sold

Contract Harvesting enables DNR to have more direct control of harvest activities in order to provide additional environmental protection as well as earn more trust revenue. DNR has sold twelve Contract Harvesting timber sales since 2SSB 5074 was signed in 2003. Harvesting has been completed on nine of those timber sales, producing 52 mmbf (million board feet³) of timber in log sort form. The remaining three sales are currently in operation and it is estimated that they will produce 17 mmbf of timber, for a total of 69 mmbf.

The legislation requires that DNR may not use Contract Harvesting for more than 10 percent of the total annual volume of timber offered for sale. The following table summarizes the sold Contract Harvesting sales and their relationship to total volume sold by DNR.

Table 1. DNR Contract Harvesting Sales Volume as a Percent of Total Volume Sold

Fiscal Year	Number of Contract Harvesting Sales	Contract Harvesting Volume (mmbf)*	DNR Total Volume (mmbf)*	Contract Harvesting as a Percent of Total Volume
FY 04	3	14	546	3%
FY 05	5	30	598	5%
FY 06	4	25	527	5%
Totals	12	69	1,671	4%

*Million board feet

Increased Revenue from Contract Harvesting Sales

Seven of the completed Contract Harvesting timber sales were selected specifically to increase revenue to the trusts. These were chosen from areas traditionally dominated by log buyers/marketers rather than mill owners. The seven sales earned more than \$10 million for the trusts.

³ A board foot is the amount of wood contained in an unfinished board 1 inch thick, 12 inches long, and 12 inches wide.

Table 2. Contract Harvesting Sales Earning Revenue for the Trusts

Sale Name	DNR Region	Volume (mbf)*	Net Proceeds**	Average Price per Thousand Board Feet
Hungry Bug Sorts	Northeast	4,484	\$1.3	\$284
Cougar Mountain Sorts	Northeast	4,494	\$0.7	\$153
Skull Sorts	Northeast	8,229	\$1.6	\$199
Ridge Wire Sorts	Northwest	3,174	\$1.2	\$394
Leftover Jam Sorts	Northwest	2,944	\$1.2	\$420
Doe Berry Sorts	Northwest	4,570	\$1.8	\$403
Dragons Back Sorts	Olympic	5,718	\$2.3	\$401
Totals		33,613	\$10.1	\$304

*Thousand board feet

**Dollars in millions

Implementation of the Contract Harvesting program has shown that significant additional revenue can be gained when this method is applied to carefully selected timber sales identified as having the potential to earn more revenue than traditional sale methods.

The Contract Harvesting sale method generates additional revenue over lump sum and scale sale methods in two ways:

- 1) Product specialization and niche marketing.
- 2) Attracting additional bidders unaccustomed or unwilling to bid on traditional DNR lump sum or scale timber sales.

For example, three sales were selected for Contract Harvesting in DNR's Northwest Region. (Table 2) Purchasing activity in this area had been dominated by a small number of larger purchasers. By identifying and marketing specialized log sorts, bidding activity increased. When compared to similar sales sold using traditional methods from the same area and time period, 15 percent more revenue was generated by Contract Harvesting sales.

Perhaps the most compelling example of increased revenue through Contract Harvesting comes from the Loomis State Forest in DNR's Northeast Region. Two Contract Harvesting sales were sold that featured dead and dying Englemann spruce logs, which are used for constructing log homes. Previously, the manufacturers of log homes had been reluctant to buy traditional DNR timber sales. In fact, when one of these sales had been offered earlier as a lump sum sale, no bids were received. When re-offered as a Contract Harvesting sale, DNR was able to attract log house manufacturers to bid on the Englemann spruce log sorts and saw log purchasers to bid on the other sorts. Two profitable sales (see Table 2 'Cougar Mountain Sorts' and 'Skull Sorts') were created where marketing options had previously been absent, earning \$2.3 million for the trusts. Without Contract Harvesting, these sales would have garnered little or no value. Additionally, this new market

has created future options for selling house logs from other DNR sales in Eastern Washington.

Finally, bidding activity on all of DNR's Contract Harvesting sales to date reveals that many new purchasers are actively bidding on Contract Harvesting log sorts. Many of these bidders prefer to buy delivered logs or are otherwise uncomfortable with DNR's lump sum and scale timber sale contract structure. The laws of supply and demand suggest that increased demand will also increase revenue to the trusts.

Increased Environmental Protection

Two DNR Contract Harvesting sales provided opportunities for collaboration with key stakeholders to achieve desired environmental protection outcomes. The 'Cougarilla 1 Sorts' sale was designed to enhance dispersal habitat for the northern spotted owl. The 'Weihl Ridge Sorts' sale addressed issues identified during DNR's public outreach process concerning recent timber harvests in the area. DNR uses the Contract Harvesting method to increase its control over the location and methods of harvest activities, thereby providing additional environmental protection for the area.

Table 3. Contract Harvesting Sales Providing Environmental Protection

Sale Name	DNR Region	Volume (mbf)*	Net Proceeds**	Average Price per Thousand Board Feet
Cougarilla 1 Sorts	South Puget Sound	13,434	\$3.7	\$279
Weihl Ridge Sorts	Southeast	5,353	\$1.3	\$245
Totals		18,787	\$5.0	\$269

*Thousand board feet **Dollars in millions

The 'Cougarilla 1 Sorts' sale, located in DNR's South Puget Sound Region, was within an area managed for conservation of northern spotted owls. This Contract Harvesting sale involved collaboration between DNR and the United States Fish and Wildlife Service (USFWS) to develop high quality habitat. As the logging progressed USFWS biologists and DNR foresters and biologists recognized that the stand density needed to be modified from the original prescription⁴ in order to create conditions more beneficial to northern spotted owls. They proceeded to make adjustments to the sale's prescription that reduced the density of the stand and increased chances for the residual stand to grow, leading to improved owl habitat. Without the operational flexibility available with the Contract Harvesting method, the change in the stand density would not have occurred and eventual higher quality northern spotted owl habitat would not have resulted.

Contract Harvesting Program Costs

Experience has determined that the costs to layout and offer a Contract

⁴ The stand objectives and activities that lead to desired future forest conditions.

Harvesting sale are essentially the same as for a traditional sale. The same amount of field reconnaissance, cruising, engineering, layout work and public outreach is required regardless of sale method. The value added to the trusts comes in additional revenues gained through product merchandising and the additional environmental protection achieved by operational controls in sensitive areas.

Key Observations and Achievements

Optimization through Product Manufacturing. With the ability to hire the harvester directly, the resulting increase in on-the-ground flexibility has enabled DNR to make necessary adjustments in the proportions of log sorts produced, optimizing the product manufacturing process and increasing the revenue generated from higher value log sorts. For example, more high value cedar poles, Douglas-fir peeler logs and house logs can be manufactured from the same trees that produce regular saw logs. Through active, on-the-ground merchandising, DNR compliance foresters can direct the harvester to increase or decrease the amount of any one log sort produced on the timber sale in order to optimize profits. The Contract Harvesting program enables public schools and other trust beneficiaries to realize this added value.

Improved Cash Flow. Historically, DNR timber sales contracts were two or three years in length. Several factors might influence when a purchaser would begin harvest operations on a lump sum or scale sale, such as the current value to be obtained at the mill for the logs, the price paid to the DNR for the timber, and the interest rate for borrowed money. With Contract Harvesting, DNR determines the timing of harvest and payment for logs. This allows DNR to influence revenue streams for the trust beneficiaries.

Customer Familiarity with a New Process Results in Increased Bidding Activity. Initially, some log purchasers were hesitant to bid on the DNR Contract Harvesting log sort sales. As customers became more knowledgeable about the Contract Harvesting process, they recognized the successes of the program and their initial hesitation declined. Log buyers now have become more comfortable with this direct business relationship with DNR and more active bidding is occurring on DNR Contract Harvesting log sort sales.

Satisfied Customers. DNR has been receiving good reviews from customers. Many have reported that the quality of logs delivered to them from DNR Contract Harvesting sales is of the highest caliber when compared to their other log sources. Recognition of good quality control has helped generate increased purchaser interest. Log purchaser confidence in DNR's ability to deliver a high quality log manufactured to the correct specifications is increasing DNR's credibility. This will likely establish a healthy and active

bidder pool and positively affect future sales.

Harvester Selection Process. The pre-qualification process used to screen harvesters has allowed DNR to select high quality operators for Contract Harvesting sales. This is vital to the success of the Contract Harvesting program. Only the most qualified operators are eligible to bid, ensuring that all jobs are completed professionally.

Ability to Treat Forests Where Health is at Serious Risk. DNR's ability to use the Contract Harvesting method and its revolving fund to treat forest stands that are overly dense or infested with or susceptible to insects, diseases, wind, ice storms, and fire has proven to be highly beneficial. Stands that DNR previously could not afford to treat with its operating budget have now had their health restored and fire hazard reduced. At the same time the net present value of the residual stands is increased.

Conclusions

The Contract Harvesting method is a highly flexible tool for helping to implement both the 1997 Habitat Conservation Plan (HCP) for forested state trust lands and the 2004 Sustainable Harvest Plan for forested trust lands in Western Washington.⁵

Forested state trust lands managed by DNR have received statewide certification under the Sustainable Forestry Initiative® Program. One of seven notable practices identified by the 2006 independent, third-party audit team, is that "...the contract harvesting program provides the DNR more operational control to implement silvicultural prescriptions, management issues, and financial returns through this delivered log program."

Contract Harvesting has provided immediate increased revenue streams to the trust beneficiaries. Contract Harvesting has allowed for better direct control necessary for implementing sensitive environmental objectives, and has allowed DNR to capture additional value where it otherwise would be limited by traditional marketing approaches. The Contract Harvesting method of selling log sorts has enabled DNR to develop new markets for timber from forested state trust lands. These new markets are benefiting local communities that are home to businesses producing wood products.

⁵ RCW 79.10.320 Sustainable harvest program.



WASHINGTON STATE DEPARTMENT OF
Natural Resources
Doug Sutherland - Commissioner of Public Lands

222

Contract harvesting

A tool for environmental protection and increased revenue

The Department of Natural Resources (DNR) manages 2.1 million acres of forested state trust land to benefit various state institutions, including schools, universities and county governments. Most revenue generated from these lands comes from the sale of timber. Generally, timber is sold by auctioning a stand of trees for harvest. The successful bidder then provides for the logging, transport and disposition of the wood.

DNR has found that for some timber sales, contract harvesting offers better options for both environmental protection and revenue. In contract harvesting, DNR contracts with a firm to log the timber and sort it into various log products based on size, species, grade, etc. DNR then sells the logs through auction to the highest bidder.

By contracting directly with the harvester, DNR has more direct control of the process – road building, selection of trees for removal, and the removal itself. This can provide more flexibility and assurance of meeting the intent of the DNR's Habitat Conservation Plan and other environmental goals.

Contract harvested timber also can bring in higher revenue. Based on pilot contract harvest sales, DNR estimates that a carefully selected contract harvest sale can increase net revenue about 15 percent above a lump sum sale for the same stand of timber. (See next page.)

Problem

The current legal requirements for distributing money received from state trust land timber sales limit the approaches that DNR can take with timber harvests and sales. This in turn limits opportunities for revenue for the trusts.

DNR's proposal

Create a self-supporting account for contract harvests. The two state land management accounts that DNR manages (Forest Development Account and Resource Management Cost Account) would make an initial contribution to the new account. Expenses for contract harvest sales would be paid from the contract harvesting revolving account, and contract harvesting receipts would replenish the account. The net proceeds from each harvest would be distributed to the trust beneficiaries and management accounts as usual.

Effects of the legislation

For timber sales where contract harvesting is the best method (about 10 percent of the sales), this bill gives DNR a viable and valuable tool that can enhance protection of the environment and trust assets, and potentially increase annual revenues by \$2.9 million.

Contact

Randy Acker,
Governmental Relations Director
902-1015

More▶

Why contract harvest?

Contract harvesting has the potential to increase revenue to the trust beneficiaries and increase environmental protection.

Pilot harvests show potential for increased revenue

Pilot contract harvesting timber sales have shown DNR is able to achieve an average increase of about 15 percent on timber prices by selling log sorts directly to log buyers. Contract harvesting has the potential for an increase of up to 22 percent on returns based on some of those pilot timber sales.

Part of the potential for increased revenue is due to increased options for purchasers:

- **Contract harvest sales let a purchaser focus on the specific log product that they want.** Purchasers may be interested in only one of the multiple high-value products contained in a stand of timber, and would not bid as high on a traditional lump sum sale that requires them to deal with disposing of the other products. Poles are one example of a high-value product. Through its pole sales program, DNR estimates that it gets 30-50 percent less for poles removed as part of a lump sum sale than it does for those sold in a separate pole sale. Similarly, in contract harvesting other specific log products can also sell for their true value. (And they will be *used* for their highest value, as well.)
- **Contract harvest sales reduce risks for purchasers on sales that have complex harvest prescriptions.** Purchasers who would normally bid on regular lump sum sales may find it difficult to estimate timber values for sales with complex prescriptions. As a result, their bids may not reflect the true value of the timber, or they may not bid at all on those sales. With contract harvesting, purchasers bid only on the delivered log sorts in which they are interested and do not have to deal with the complexities or risks of harvesting.

One pilot contract harvest sale had originally been offered as a lump sum sale, but no one bid on it. It was later offered under similar market conditions as a contract harvest sale with seven log sorts. The contract harvest sale generated revenue twice the amount of the minimum bid price for the original lump sum sale.

Environmental protection

DNR manages state forests to produce revenue while protecting habitat for many types of wildlife. At some sites, this can lead to complex harvesting prescriptions. In such cases, having a direct contractual relationship with the harvester will increase the likelihood of achieving the specific desired ecological results, including DNR's compliance with its Habitat Conservation Plan because DNR retains the flexibility to revise the harvest as necessary to protect habitat.